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No. 89-666

In the Supreme Court of the United States

OCTOBER TERM, 1989

WEST VIRGINIA STATE MEDICAL ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a loss incurred by a tax-exempt medical association from selling advertising space in its professional journal may be offset against its taxable income derived from another source, where it does not engage in the advertising activity with the intent to produce a profit.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-5) is reported at 882 F.2d 123. The opinion of the Tax Court (Pet. App. 6-19) is reported at 91 T.C. 651.

JURISDICTION

The judgment of the court of appeals was entered on August 16, 1989. The petition for a writ of certiorari was filed on October 12, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a medical association that is exempt from federal income tax as a "business league," pursuant to Sec-

tion 501(c)(6) of the Internal Revenue Code.[1] Like other tax-exempt organizations, however, it is subject to tax on income unrelated to its exempt purposes, pursuant to Sections 511-513 of the Code.[2] In furtherance of its exempt purpose, petitioner publishes a monthly medical journal that is circulated to its members. It sells advertising space in the journal to providers of medical products and services; the sale of advertising space is not related to its exempt purpose. Petitioner has not made a net profit from its advertising activity since 1962. During the 1974-1986 period, it incurred annual losses from that activity ranging from $18,874 to $63,786. Apart from its advertising activity, petitioner receives commission income from endorsing and marketing the services of a company that collects delinquent accounts for physicians. This marketing activity is not related to petitioner's exempt purpose. Pet. App. 8, 10-11.

On its 1983 federal income tax return, petitioner reported commission income of $9,908. It also reported $33,163 in gross advertising income, from which it deducted $54,973

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[1] Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) (the Code or I.R.C.), as in effect during 1983, the tax year involved.

[2] These provisions impose a tax, at regular corporate rates, on the "unrelated business taxable income" of otherwise tax-exempt organizations. For a business league, the phrase "unrelated business taxable income" is defined by Section 512(a)(1) to mean "the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business." Section 513(a) defines an "unrelated trade or business" as "any trade or business the conduct of which is not substantially related * * * to the exercise or performance by such organization of its [exempt function]." Section 513(c) defines a "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services."

of advertising costs, resulting in a loss of $21,810 from its advertising activity for 1983. Petitioner then offset the advertising loss against its commission income and reported zero unrelated business income tax liability for 1983. The Commissioner determined that, because its advertising activity was not a trade or business entered into for profit, petitioner's advertising expenses were deductible only up to the amount of its gross income from that activity; therefore, the loss from petitioner's advertising activity could not offset its unrelated business income from commissions.[3] Pet. App. 2, 10-11.

2. Petitioner sought redetermination of the resulting $1,336 deficiency in the Tax Court, which upheld the Commissioner's determination (Pet. App. 6-19). The court reasoned that the phrase "trade or business" as used in Section 512(a)(1) has the same meaning as in Section 162 of the Code, which generally authorizes deductions for non-exempt organizations for expenses incurred in "carrying on any trade or business." See Pet. App. 16. Quoting *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987), the court observed that, to be a trade or business for purposes of Section 162, "the taxpayer's primary purpose for engaging in the activity must be for income or profit" (Pet. App. 18). The court found that petitioner's history of 21 consecutive years of losses, coupled with its failure to explain why it continued to incur losses that could have been avoided if it discontinued the advertising activity, established that peti-

[3] This determination reflects the general rule under the income tax law that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See I.R.C. § 183; *Five Lakes Outing Club* v. *United States*, 468 F.2d 443, 446 (8th Cir. 1972) (allowance of expenses up to, but not exceeding, gross income from not-for-profit activity is "the procedure the Commissioner has long used with court approval").

tioner did not engage in that activity for profit. *Id.* at 19. Accordingly, the court concluded that petitioner's advertising activity was not a trade or business for purposes of Section 512(a)(1) and, therefore, that petitioner could not deduct against other unrelated business income the excess expenses incurred in conducting that activity.

3. The court of appeals affirmed (Pet. App. 1-5). The court agreed with the Tax Court's analysis that the phrase "trade or business" has the same meaning in Section 512(a)(1) as in Section 162, and therefore that the deductibility of petitioner's loss from advertising depends upon whether the loss resulted from an activity that is conducted with the intent of making a profit. In so holding, the court rejected petitioner's contention that advertising activity conducted by an exempt organization is automatically a "trade or business" under Section 512, irrespective of the existence of a profit motive. The court explained (Pet. App. 4-5): "The determinative factor then is not whether advertising generally is a trade or business, * * * but whether the advertising business conducted by [petitioner's] journal is the kind of trade or business in which losses are considered deductible under the 'for profit' rationale of § 162, *i.e.*, that the activity for which a loss is incurred was entered into primarily for profit." Applying that standard, the court agreed with the Tax Court's finding that petitioner had failed to establish the requisite profit motive for its advertising activity, noting that petitioner had incurred direct advertising costs resulting in substantial losses for 21 consecutive years (Pet. App. 5).

ARGUMENT

Petitioner contends that any advertising activity conducted by an exempt organization necessarily qualifies as a "trade or business" for the purposes of Sections 511-513 of the Code, irrespective of the lack of a profit motive for

the advertising activity. The court of appeals correctly rejected that contention, and its decision does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no reason for review by this Court.

1. Section 513(c) of the Code defines a "trade or business" for purposes of unrelated business income taxation as "any activity which is carried on for the production of income from the sale of goods or the performance of services." The relevant Treasury Regulation, 26 C.F.R. 1.513-1(b), provides that "in general, any activity of [an exempt] organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162" is a trade or business under Section 513(c). See generally *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 (1986). As this Court has noted, "[t]he standard test for the existence of a trade or business for purposes of § 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit' " (*id.* at 110 n.1, quoting *Brannen* v. *Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). Thus, the courts generally have "adopted the 'profit motive' test to determine whether an activity constitutes a trade or business for purposes of the unrelated business income tax." *United States* v. *American Bar Endowment*, 477 U.S. at 110 n.1 (citing cases). Because the deductions available to petitioner in determining its "unrelated business taxable income" are confined by the language of Section 512(a)(1) to those incurred in a "trade or business," it follows that petitioner may deduct against its commission income the expenses incurred in carrying on its advertising activity only if that advertising activity is carried on with an intent to make a profit. Petitioner, however, does not dispute the factual conclusion of the courts below that it lacked a profit motive for its advertising activity.

Petitioner's contention is that the above principles do not apply to advertising activities, but rather that these activities constitute a "trade or business" under Section 513(c) even in the absence of a profit motive. This contention is clearly belied by the statute. Section 513(c), which is captioned "Advertising, etc., activities," defines a "trade or business" as "any activity which is carried on *for the production of income* from the sale of goods or the performance of services" (emphasis added). Therefore, the statute explicitly contemplates that advertising activity must be profit-motivated in order to constitute a "trade or business." Moreover, a major impetus for the enactment of that provision was the desire to establish that a tax-exempt organization's sale of advertising in a trade or professional journal may be "fragmented" as an activity separate from the publication of the journal's editorial content. See *United States* v. *American College of Physicians*, 475 U.S. 834, 839-840 (1986).[4] Thus, there is no basis whatsoever for excepting advertising from the general principles underlying Section 513(c). And the legislative history of the statute confirms what is strongly indicated in its text—namely, that those general principles restrict a tax-exempt organization from reducing its unrelated business taxable income by losses arising from the publication of a journal or other periodical unless the organization carries on the publishing activity with

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[4] Before this statute was enacted in 1969, tax-exempt publishers had argued that the unrelated business income tax did not apply to their advertising profits on the ground that the advertising constituted part of a unified publishing business with a dominant educational (and exempt) purpose. Section 513(c) rejects that argument, and endorses the concept of "fragmentation," by providing that "an activity does not lose identity as a trade or business merely because it is carried on * * * within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

the intention of producing a net profit. See H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 50-51 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 76 (1969).

2. Contrary to petitioner's contention (Pet. 8-9), nothing in this Court's decision in *United States* v. *American College of Physicians, supra*, suggests that advertising activity can be treated as a "trade or business" if it is not profit-motivated. In contrast to petitioner, the tax-exempt medical association in *American College of Physicians* made a net profit from the sale of advertising space in its journal (see 475 U.S. at 836), and therefore the case did not involve the question presented here of the deductibility of *excess* expenses in computing unrelated business taxable income under Section 512(a)(1). Rather, the question in that case was whether the profits derived from the advertising, which the association had conceded to be a "trade or business," were exempt from the unrelated business income tax on the ground that the advertising activity was "substantially related" to the organization's educational purposes.

Petitioner thus takes out of context the statements in *American College of Physicians* on which it relies. This Court observed that the enactment of Section 513(c) "established advertising as a trade or business, the first prong of the inquiry into the taxation of unrelated business income." 475 U.S. at 840. Similarly, the Court noted that "[s]atisfaction of the first condition is conceded in this case, as it must be, because Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial comment" (*id.* at 839). These statements merely explain Congress's acceptance in 1969 of the principle of "fragmentation" as applied to a tax-exempt publisher's advertising profits (see p. 4 and note 4, *supra*) and note that the taxpayer was not contesting the treatment of its advertising activity as a "trade or business"

distinct from the exempt aspects of its publication activity. This Court in *American College of Physicians*, however, clearly did not consider, or purport to give an opinion on, whether the sale of advertising constitutes a trade or business where, as here, it is carried on without a motive to make a profit. Accordingly, there is no conflict between the decision below and this Court's decision in *American College of Physicians*.

Petitioner's claim of a conflict in the circuits is similarly without merit. In *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41* v. *Commissioner*, 833 F.2d 717 (7th Cir. 1987), the court of appeals rejected the argument of a tax-exempt association that its advertising should not be regarded as a trade or business under Section 513(c) because it did not result in unfair competition with other advertisers. The court explained that this Court's decision in *American College of Physicians* "recently removed any remaining doubts on whether paid advertising constitutes a 'trade or business' under section 513(c)." 833 F.2d at 722. Like this Court in *American College of Physicians*, the court of appeals made this statement in the course of explaining Congress's adoption of the principle of "fragmentation" and its attendant rejection of the proposition that the placement of advertising in a publication prepared for tax-exempt purposes is a sufficient basis for failing to treat the advertising activity as a "trade or business." As in *American College of Physicians*, the advertising activity of the association in *Fraternal Order of Police* was conducted for profit, and the court had no occasion to consider whether losses from such activity, if it had not been carried on for profit, could be offset against taxable income from another source. Indeed, the court explicitly noted that the existence of a profit motive is the standard test for determining whether an activity constitutes a trade or business (833 F.2d at 722) and proceeded to rely on the association's concession that it "intended to,

and did, profit from the sale" (*id.* at 723). Thus, the Seventh Circuit's decision is fully consistent with the reasoning of the court below.[5]

Petitioner's reliance on the Commissioner's regulations (Pet. 10-11) is similarly misplaced. Treas. Reg. § 1.512(a)-1, which petitioner quotes in part (Pet. 10), specifically states that deductible expenses "must be directly connected with the carrying on of unrelated trade or business." Petitioner's partial quotation of Treas. Reg. § 1.512(a)-1(f)(2)(i) omits the definition by cross-reference of "direct advertising costs"—*i.e.*, "determined under subparagraph (6)(ii) of this

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[5] As the court of appeals noted (Pet. App. 4 n.*), there is a conflict among the circuits concerning the determination of the "unrelated business taxable income" of tax-exempt social clubs under Section 512(a)(3), but that conflict has no bearing here. Compare *Cleveland Athletic Club, Inc.* v. *United States*, 779 F.2d 1160 (6th Cir. 1985), with *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833 (2d Cir. 1986), *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750 (9th Cir. 1989), and *Portland Golf Club* v. *Commissioner*, No. 88-7218 (9th Cir. Mar. 6, 1989), petition for cert. pending, No. 89-530. These cases involve the question of the correct method for determining whether the exempt organization has a profit motive in engaging in a particular activity. Specifically, in these cases, the clubs earned gross income from certain activity unrelated to their exempt purposes (the sale of food and drink to nonmembers), but reported losses from that activity because their total expenses, including a portion of the fixed overhead allocated to that activity, exceeded the gross income. The courts of appeals have divided on the merits of the clubs' argument that, despite these losses, they had the requisite profit motive in conducting the activity in question because they intended that the gross income from the nonmember activity would exceed the *variable* expenses, albeit not all of the expenses (both fixed and variable) allocable to that activity. All of these courts agree, however, that the existence of a profit motive is a prerequisite to the deduction under Section 512(a)(1) of excess expenses arising from a particular activity (see Pet. App. 4 n.*, 18), and therefore all of these courts would have rejected the contention of petitioner, which has not argued that it conducted its advertising activity with the motive of earning a profit.

paragraph." That subparagraph in turn specifies that these costs "are allowable as deductions in the computation of unrelated business income * * * to the extent they meet the requirements of section 162, section 167 [which allows a deduction for the depreciation of property used in a trade or business] or other relevant provisions of the Code." Treas. Reg. § 1.512(a)-1(f)(6)(ii). Thus, like Section 512(a)(1) itself, the regulations manifestly do not allow petitioner to deduct advertising costs that exceed its gross income from advertising unless its advertising activity is conducted for profit, and therefore qualifies as a trade or business for purposes of the income tax provisions of the Code.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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